

Inflation Report

October - December 2004

Monetary Program

For 2005

Summary

The world economy continued to grow at a favorable pace in 2004. Despite the fact that the global economy is expected to exhibit a moderate reduction in its growth rate, forecasts for 2005 remain positive. In particular, the U.S. economy is anticipated to grow closer to its potential rate. Furthermore, U.S. industrial production continued to expand and is anticipated to grow at a higher rate than GDP. CPI inflation is expected to decline; nonetheless, core inflation is anticipated to stabilize at around the same level observed at the end of 2004.

In 2004, international financial markets exhibited low volatility, ample liquidity, and a significant search for higher yields. Such conditions prevailed despite the fact that by mid-year the Federal Reserve Board began its cycle of monetary policy actions to withdraw the monetary stimulus. This was due, among other developments, to the fact that U.S. core inflation and its expectations have remained relatively contained and, therefore, have allowed U.S. monetary policy actions to be implemented at a measured pace.

Under such conditions, the Mexican economy grew at an annual rate of around 4.7 percent during the fourth quarter of 2004. The strength of the demand for Mexican exports and the availability of resources to promote domestic demand deserve mention. The expansion of industrial and manufacturing production was favorable and contributed to job creation. Nonetheless, the rate at which employment had

been growing eased during the fourth quarter of 2004.

The contribution to world GDP growth of several Asian economies, especially the Chinese, continued to increase in 2004. The expansion of such economies has been characterized by their intensive use of energy, metals and other raw materials, as well as a considerable increase in several food imports. Consequently, there were considerable pressures on these commodity prices in international markets, therefore affecting CPI inflation. Furthermore, during the fourth quarter of 2004, different weather-related factors affected supply conditions of many fruits and vegetables in Mexico and the U.S. Given their nature, the abovementioned supply shocks mostly affected CPI's non-core component and the food items of the core merchandise price subindex.

Banco de México will remain attentive so that no sequels to the significant rebound in inflation in 2004 arise. In particular, it will monitor the pressures to inflation that could originate from the demand side and from wage negotiations, in order to foster monetary conditions that facilitate the convergence of inflation to its target.

Recent Developments in Inflation

Developments in Inflation in 2004

At the end of the fourth quarter of 2004, annual CPI inflation closed at 5.19 percent, 1.21 percentage points above that recorded at the end of the previous year. During the same comparison

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period, annual core inflation and non-core inflation rose by 0.14 and 3.54 percentage points, respectively. The main inflation pressures observed during 2004 originated from commodity price increases in international markets. In this regard, the following deserves mention:

- (a) The increase in international energy prices affected negatively administered prices: their annual variation increased from 6.11 percent at the end of 2003 to 10.02 percent at the end of 2004. Household gas prices exhibited a significant increase in their annual variation rate: from 7.75 to 18.27 percent during the referred period.
- (b) The annual variation rate of livestock goods' prices rose from 8.34 percent at the end of 2003 to 12.9 percent at December 2004. Such prices were affected by three factors: an increase in global demand for this type of goods; sanitary problems that led to a reduction in world beef production, which, in Mexico, was heightened by authorities' restrictions on beef imports; and higher production costs originated by the price increase in grain forage for cattle.
- (c) Among other factors, price increases in both livestock products and several grains and cereals, which are used as inputs in many processed foods, affected the latter's prices. This was reflected in a significant rise in food prices within the core merchandise subindex, which increased their annual variation from 4.70 percent in December 2003 to 7.04 percent at the end of 2004.
- (d) An increase in the subindex of regulated prices, due mainly to the rise in public transportation fares in Distrito Federal (Mexico City) and Estado de México.
- (e) Price increases in several fruits and vegetables during the second half of 2004, stemming from the reduction in the supply of some of these products due to adverse weather conditions in Mexico and the U.S. (fruits and vegetables recorded an annual

variation from -2.36 percent in December 2003 to 6.43 percent at the end of 2004).

Annual core inflation was 3.80 percent at the end of 2004, 0.14 percentage points above its previous year figures. This was due to the differing trends within its components. The annual variation rate of the merchandise subindex increased 1.25 percent during the referred period, while that of the services' subindex partially offset such effect by falling 1.12 points. The increase in processed food prices mainly accounted for the increase in merchandise price inflation. Regarding the services' subindex, prices of services excluding housing grew at a slower growth rate during the fourth quarter of 2004. Nonetheless, their annual variation rose in the last months of 2004.

Developments in Inflation: October-December 2004

During the fourth quarter of 2004, additional supply shocks affected a small number of items of the non-core price index. In particular, during such period, the annual growth rate of tomato prices rose from 12.44 to 23.24 percent, while that of household gas prices did so from 14.28 to 18.27 percent.

Annual core inflation was 3.80 percent at the end of 2004, while at the end of September it was 3.76 percent. Such result was due mainly to a 0.05 percentage point increase in the annual variation rate of the merchandise subindex. The latter responded, to a great extent, to the persistent negative effects originated by the previous price increases of several commodities used as inputs in food manufacturing. Nonetheless, such effect began to dissipate in November and December, which, in turn, contributed to moderate the upward path followed by merchandise prices.

During the reference period, the annual rate of variation of the services' price subindex rose 0.03 percentage points. As for its components, the housing subindex's annual variation fell, nearly offsetting the increase in the rest of the services' price subindex. The latter's annual growth rate rose from 3.40 percent in September to 3.74 percent in December. Such result was mainly

attributed to the price increase in several commodities that are demanded by suppliers of certain services included in this subindex.

Main Determinants of Inflation

The world economy continued to recover during the fourth quarter of 2004. Global growth was mainly driven by the strength of economic growth in the U.S. and in East Asian emerging economies. Growth in the euro area and in Japan continued to be affected by the appreciation of their currencies and by the increase in crude oil prices, among other factors.

The most significant aspects characterizing financial and exchange markets during the fourth quarter were the continuance of the gradual withdrawal of the monetary stimulus in the U.S. and the significant depreciation of the US dollar vs. other main currencies. World economic growth along with ample liquidity, investors' search for higher yields, and the improvement in many emerging economies, led to a strong rebound in the issuance of emerging economies' bonds, and to a reduction of their sovereign debt spreads to historically low levels. Despite the fact that forecasts point to a moderate slow down in world economic growth for 2005, the favorable external conditions are expected to continue.

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Economic activity in Mexico in 2004 differed significantly from that in 2003: the pace of growth strengthened and the contribution of aggregate demand components to GDP growth was more balanced.

In 2004, GDP growth increased considerably. All items of aggregate demand contributed to such result: the external sector (through the increase in exports of goods and services); investment expenditure recovered after contracting for three years in a row; and consumer expenditure, the most significant item of aggregate demand, expanded considerably. Such results fostered an improvement in formal sector employment.

As for GDP and aggregate demand, during the fourth quarter both items grew vigorously at an

annual rate due to favorable external conditions stemming from the strong demand for Mexican exports, and to the ample availability of resources, which have boosted expenditure. Among the latter, the most significant have been oil revenues, workers' remittances, and the fast pace of growth of consumer and mortgage lending. Such results fostered the continuous growth in consumption expenditure and the recovery of investment.

During the fourth quarter of 2004, annual GDP growth is expected to have been around 4.7 percent during the fourth quarter of 2004, slightly above that of the third quarter. Such result implies that during the entire year GDP would have grown approximately 4.2 percent, the highest growth rate in the last four years.

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During the fourth quarter of 2004, Mexico's external sector was characterized by the following: a) a significant annual increase in non-oil exports; b) a high value of crude oil exports, which declined gradually during the quarter; c) the rapid expansion of merchandise imports (especially of capital goods, which rebounded significantly); d) moderate trade and current account deficits, which, however, were significantly wider than those recorded in the third quarter. Such results are attributed to both the higher growth in domestic demand during the quarter as compared with that of GDP and to seasonal factors; e) significant workers' remittances; f) a capital account surplus, which easily financed the current account deficit; and g) a significant accumulation of international reserves.

Monetary Policy Actions

In 2004, monetary policy faced the following challenges:

- (a) Containing the effects of price increases in several commodities to inflation expectations and wage negotiations.
- (b) Limiting inflation pressures that could originate from the economy's cyclical recovery.

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- (c) Fostering an orderly adjustment of the economy to an environment of tighter global monetary conditions.

Two phenomena caused a further rise in inflation during the fourth quarter of 2004: i) the significant increase in some fruits and vegetables' prices, such as tomato, due to specific problems in their supply; and ii) the marked incidence of administered prices on CPI inflation, due mainly to the increase in household gas prices.

Just as in the case of other supply shocks that arose during the year, price increases only affected specific items and did not lead to an overall upward movement of prices.

Nonetheless, given the number and magnitude of the supply shocks in 2004, medium-term inflation expectations were revised upward significantly.

Under such environment, and in order to prevent wage negotiations and price determination from being contaminated, the Board of Governors of Banco de México tightened the monetary policy stance considerably in 2004. This was done mainly through two channels:

- (a) By increasing the *corto* (short position) on nine occasions. During the fourth quarter, it was done on three occasions: on October 22, from 51 to 57 million pesos; on November 26, to 63 million pesos; and on December 10, to 69 million pesos.
- (b) By stating in its press releases on monetary policy that, until deemed necessary, domestic monetary conditions should mirror, at least, the greater monetary stringency that prevails in the U.S.

As a result of the abovementioned monetary policy actions, short-term domestic interest rates rose significantly: the interbank funding rate increased 114 basis points in the last quarter of 2004, 263 basis points in 2004, and more than 400 basis points above its lowest level during the year (January 19).

The combination of Banco de México's monetary policy actions and the relatively ample liquidity

conditions prevailing in world financial markets have led to both a significant "flattening" of the yield curve in pesos, and to interest rate spreads between Mexico and the U.S. that have widened in the short term and narrowed in the long term.

In 2005, Mexican monetary policy will continue to face significant challenges to abate inflation; however, their relative importance will probably differ from that observed in 2004. Although the Central Bank will remain attentive so that no sequels from the significant increase in CPI inflation in 2004 take place, it will particularly monitor aggregate demand and any demand side pressures to inflation. Should this occur, Banco de México will act promptly to limit inflation pressures associated with the economic cycle and to reestablish inflation expectations' path to the inflation target.

Private Sector Outlook: 2004-2005

In the survey conducted in mid-December, private sector economic analysts' forecasts were as follows: i) GDP is expected to have grown 4.08 percent in 2004; a slight reduction in GDP's growth rate is expected for 2005 and 2006 (3.74 and 3.83, respectively); ii) in 2005, 401 thousand jobs are expected to be created in the formal sector; iii) expectations regarding domestic interest rates for the following months were revised upward as compared with those forecasted in September; iv) expectations regarding the peso exchange rate for the following months and for the end of 2005 were revised downward as compared with those forecasted in September; v) moderate trade and current account deficits are expected for 2004 and 2005; vi) inflation for 2005, 2006, 2007 and the average for 2006-2009 is expected to reach 4.32, 4.09, 3.95 and 3.91 percent, respectively (after the publication of inflation results for December 2004 and for the first half of January 2005, some indicators of inflation expectations, obtained from surveys conducted more frequently, have shown a certain reduction).

Balance of Risks and Final Remarks

Considering the abovementioned macroeconomic environment and most recent information on the development of the Mexican economy, Banco de México's baseline scenario for 2005 is as follows:

GDP Growth: GDP is expected to grow between 3.5 and 4.0 percent.

Employment: At the end of the year, nearly 400 thousand jobs are expected to be created in the formal sector.

Current Account: A moderate current account deficit of the balance of payments is expected (2 percent of GDP).

Inflation: CPI inflation is expected to follow a downward trend and, at the end of the year, to fall within the variability interval set around the inflation target. Such consideration is based on the following:

Regarding non-core inflation and its impact on CPI inflation:

- (a) The prices of several commodities, which have increased significantly, are expected to exhibit a more favorable behavior. Such consideration is based on the prevision that the world economy growth rate will ease slightly and to the fact that the supply of such goods has increased along with their production profitability. Energy prices have probably reached their highest levels, while prices of certain grains and cereals and other basic foodstuff commodities have fallen.
- (b) Prices of meat products increased sharply in 2004. Futures' markets suggest that prices of pork meat will fall in 2005, while those of beef will remain stable. Should this be the case, the annual price variation of such items would decline.
- (c) Goods and services with prices administered by the public sector are expected to follow a path in line with the one suggested by futures' markets. This applies for gasoline at the borders, and for propane and natural gas. As

for electricity rates, the federal government has announced that it will moderate its increments.

- (d) The supply shocks that led to an upward revision in inflation expectations have started to ease; consequently, the latter have begun to be revised downward. This suggests that an inflection point in inflation expectation's trend might have already taken place.
- (e) Supply shocks apparently have had a limited effect on wage negotiations.

Regarding core inflation:

- (f) Concerning the merchandise subindex, annual food inflation is expected to decline in line with the development of food prices in the international markets. The other items of the merchandise subindex are expected to follow a lateral trend. Consequently, the trend for total core merchandise inflation is expected to decline in 2005.
- (g) The annual variation of the housing services' subindex is expected to remain around its current levels, while that of the rest of the services could continue to increase in the following months and afterwards stabilize. The latter consideration is based on the fact that the increase in certain services' prices is mainly attributed to the higher prices of certain commodities which are used as inputs in the production of such services. As long as the outlook for commodity prices improves and no pressures on wages arise, services' inflation would be expected to eventually stabilize after the mentioned rebound. Summing up, total core services' inflation is expected to follow a moderate upward trend in the first months of the year and then remain stable.
- (h) The path of total core inflation will mainly depend on the development of prices of both food and services excluding housing (items that have practically the same weight in the CPI). Therefore, total core inflation is expected to follow a lateral path in the first

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months of 2005 and afterwards begin to decline.

Should the abovementioned outlook for the different price subindexes materialize, CPI inflation at the end of 2005 would be expected to reach levels similar to those observed at the end of 2003.

Should such scenario materialize, the reduction in CPI inflation in 2005 would mostly be attributed to the non-core component. Such consideration confirms that the convergence of inflation to its target still faces significant challenges. In particular:

- (i) Core inflation has exhibited certain resistance to decline.
- (ii) Core services' inflation excluding housing has rebounded, due mainly to the increase in food and energy prices in the previous months.
- (iii) Both the levels of core inflation and its expectations suggest that the long-term inflation target has still not been included in the overall process of price formation.

Under such context, Banco de México will conduct monetary policy so as to procure that monetary conditions facilitate the convergence of inflation to its target.

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The expected macroeconomic scenario is mainly subject to two types of risks that act in opposite direction: those affecting inflation and those affecting growth.

Regarding the former, inflation pressures from U.S. and world aggregate demand could heighten. Such scenario could also have the following consequences: i) external interest rates would be pressured upward, which, in turn, would lead to a worsening in emerging economies' conditions to access external financing; and ii) international commodity prices could continue to increase.

Most likely, the major risks associated with inflation abatement stem from Mexico's domestic

economic conditions. In this regard, Banco de México will monitor closely the development of aggregate demand and wage negotiations, as well as any pressures that both could have on inflation.

As for risks associated with economic growth, U.S. economic activity could slow down significantly. Additional price increases in crude oil and its by-products or a sharp decline in real estate prices may contribute to this scenario. Under such setting, the Mexican economy would be affected by a decrease in the demand for its exports, which, in turn, would reduce forecasts for growth and employment.

Other series of events could affect the Mexican economy. Nonetheless, there are two additional sources of uncertainty that, given their nature, could affect the economy in a longer horizon:

- (a) The unprecedented level of the U.S. current account deficit seems to be unsustainable in the long run. That is, the net debtor position of the U.S. economy may turn unsustainable in the future. Should this scenario materialize, volatility in financial markets would increase significantly, restricting financing access to emerging markets. Furthermore, the contraction of external demand would slow economic activity significantly.
- (b) As 2006 federal elections in Mexico near, adverse conditions for the economy could materialize: i) the lack of consensus to reach agreement on the structural reforms needed to increase the competitiveness of the economy could be further complicated; and ii) political uncertainty could increase the volatility in Mexican financial markets.

A careful evaluation of the abovementioned risks indicates that in the following months, the economy's macroeconomic anchorage, of which monetary policy plays a crucial role, will probably gain relevance. For this reason, it is very important that an autonomous institution like Banco de México has price stability as its main goal.

Throughout the world, inflation abatement is a gradual process that must be assessed in the long term. Therefore, although a series of exceptional shocks entangled such process during 2004, the Central Bank reiterates its commitment to price stability and, therefore, to safeguard the basic conditions to produce and invest. By doing so, Banco de México will contribute to an environment of certainty, which, to the extent possible, isolates economic activity from eventual external or domestic shocks, and takes advantage of the country's growth potential.

Monetary Program for 2005

Banco de México's monetary policy is conducted in order for annual CPI inflation's rate to reach 3 percent and remain permanently at that level, considering a variability interval of plus/minus one percentage point. Therefore, the inflation target operates continuously and not only for annual inflation at the end of the year. The variability interval is intended to accommodate temporary shocks to relative prices, which usually have a transitory effect on inflation.

Monetary policy decisions are based on a systematic analysis of the current economic conditions and of the inflation pressures originated by such conditions, using a wide range of variables and indicators and different economic and statistical models. Such analysis allows to identify the factors that affect the expected development of inflation and to evaluate its impact on economic agents' inflation expectations.

The implementation of Banco de México's monetary policy allows interest rates to be determined freely in the money market. Nonetheless, the Central Bank can influence them whenever it perceives that monetary conditions are not compatible with the attainment of the inflation target. This has been achieved through different channels, which allow the Central Bank to communicate to the public its monetary policy stance. In this regard, the changes in Banco de México's objective for commercial banks' daily balances at the Central Bank (*corto*) and the

statements included in the monetary policy press releases deserve mention.

Monetary conditions are, in general, the result of the interaction of money market participants and the monetary authority. The change in the amount of money that is supplied at interest rates different from those in the money market (the change in the objective for daily balances or *corto*), and Banco de México's statements included in its monetary policy press releases, are some of the elements used to make monetary conditions and inflation expectations compatible with the Central Bank's inflation target.

In order to attain price stability via an inflation targeting framework, the Central Bank must transmit clearly to the public its objectives, strategy and instruments.